UK Employment Arrangements

UK Publishes Proposed Tax Measures Against Dual Contracts

SUMMARY
The UK government has published the draft legislation announced in December’s Autumn Statement to “end the abuse of dual contracts”. Dual contracts have in particular been used by employees resident, but not domiciled, in the United Kingdom to benefit from the UK’s remittance basis of taxation for their income from overseas duties, while also working in the UK for a related employer.

Under the proposals, where:

- the employee holds separate employments inside and outside the UK;
- the employers are the same or “associated” with each other;
- the UK employment and the relevant employment are “related”; and
- the credit that the UK would allow for foreign tax on the income is less than 75% of the UK’s top rate of tax for employment income (currently 45%),

the employee will be taxed as the income arises, not when it is remitted to the UK.

The new rules would apply from 6 April 2014 onwards.

The proposals are almost certain to become law, but the details may change. Employers and employees operating dual contract arrangements should monitor the proposals as they develop up to 6 April and beyond.

BACKGROUND
The UK government published its Autumn Statement on 5 December 2013. In his speech the Chancellor of the Exchequer announced, among other proposed changes, that the government would “end the abuse of dual contracts”.

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“Dual contracts” are arrangements in which a UK-resident (but not UK-domiciled – a “non-dom”) employee enters two separate employment contracts, one covering duties to be performed inside the UK, the other covering duties to be performed outside the UK. This allows the employee to access beneficial UK tax treatment. Specifically, where an individual:

- is resident for tax purposes, but not domiciled in, the UK;
- carries out duties under an employment contract wholly outside the UK (except for “merely incidental” duties); and
- does so for a non-UK-resident employer,

the income from that contract is taxable in the UK only to the extent “remitted” (brought in) to the UK.¹ Often the two contracts will be with related employers (or even the same employer). For some years the UK government has viewed these arrangements with disfavour. Anti-avoidance rules may limit the amount benefiting from the remittance basis to a “reasonable” proportion of the employee’s total remuneration, taking into account the nature of and time devoted to the UK and non-UK duties, and any other relevant circumstances.²

In addition, HM Revenue and Customs has subjected dual contracts to close scrutiny, focusing in particular on whether there are truly two separate employments (or just a geographical split of a single employment) and whether any duties of the foreign employment contract that are performed in the UK are truly “incidental” to those performed outside the UK. This requirement that the duties of the foreign employment be performed outside the UK causes particular compliance difficulties for mobile employees in the era of equally mobile communications: incidental duties are defined very narrowly.

For non-doms who have been resident outside the UK for three UK tax years and then come to the UK, there is a more generous relief: overseas workday relief. This is available for the three years after the move, and allows the taxpayer to benefit from the remittance basis for remuneration attributable to duties performed outside the UK, whether or not performed under a contract also involving UK duties. The current proposal does not touch overseas workday relief.

The Autumn Statement gave little detail on the changes, saying only, “From April 2014, UK tax will be levied on the full employment income where a comparable level of tax is not payable overseas on the overseas contract.” When the government published its draft Finance Bill for 2014 the week after the Autumn Statement, it said that a draft of the legislation would follow in January.

¹ Whether and when income is remitted to the UK is a highly technical question, especially since the rules on constructive “remittances” were greatly extended in 2008. Some long-stay residents must pay an annual fee to benefit from the remittance basis of taxation.

² These rules apply where the employers under the two contracts are the same or “associated”. Employers are “associated” if one “controls” the other, or they are under common “control”. How “control” is defined depends on whether the employers are individuals, partnerships or companies: if both are companies, the definition is particularly wide.
THE DRAFT LEGISLATION

For the proposed rules to apply to a contract for non-UK duties which would otherwise benefit from the remittance basis, four conditions must be met:

- the employee must also hold a “UK employment” in the year (or UK part of a split year);
- the two employers must be the same or “associated” with each other;
- the two employments must be “related” to each other;
- the credit that the UK would allow for foreign tax on the income – if it were not subject to the remittance basis – is less than 75% of the “additional rate” for the relevant tax year.

If enacted, the rules will apply (or not) separately to each contract for overseas duties. Where they apply, the remittance basis will be denied for the income arising from the employment in that tax year. This includes income from employment-related securities (such as shares and share options)\(^3\) and “disguised remuneration”\(^4\) as well as plain vanilla salary.

The rules are to apply from the tax year 2014-2015 – that is, for income arising from 6 April 2014. According to HMRC’s note on the impact of the proposal, the changes are expected to affect only 350 people. The deadline for comments is 13 February.

**Condition 1: the employee must also hold a UK employment**

A “UK employment” is one “the duties of which are not performed wholly outside the United Kingdom” (save for duties which are wholly incidental): in other words, an employment to which the remittance basis would not apply.

**Condition 2: the two employers must be the same or “associated”**

The definition of “association” is the potentially broad control-based definition described above which the existing anti-avoidance rules use in targeting artificial allocations of remuneration. The new rules will therefore not apply if the two employers in question are genuinely unconnected.

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\(^3\) The UK’s Office of Tax Simplification recommended that the provisions applying the remittance basis to employment-related securities be simplified, and the government accepted the recommendation. Its proposed amendments are also in the draft Finance Bill and are intended to apply to securities and securities options acquired on or after 1 September 2014 (except for securities acquired under options acquired before that date). The proposed dual contracts changes would apply to both sets of rules.

\(^4\) Remuneration provided through third parties: the subject of complex anti-avoidance legislation in 2011.
Condition 3: the two employments must be “related”

The "related" concept is intended to ensure that only employments which are genuinely separate are not caught. The term is not defined as such. Instead, the draft rules set out a (non-exhaustive) list of situations in which employments are to be considered related.\(^5\) These are that:

- it is reasonable to suppose that the employee would not hold one employment without the other;
- it is reasonable to suppose that both employments will end at the same time or that, if one ends, the other one will too;
- the terms of one employment refer to those of the other;
- the performance of duties of one employment depends on or is linked to performance of the other;
- the duties of the employments are wholly or mainly of the same type (although performed in different locations);
- both employments involve serving the same customers or clients; or
- the employee is sufficiently senior (a director, a senior employee or one of the highest-paid employees) in either company or any company associated with them.

Moreover, Her Majesty’s Treasury may amend the list by regulation (with Parliamentary approval).

Condition 4: the 75% formula

The final condition is that the credit that the UK would allow for foreign tax on the income from the employment, if it were not subject to the remittance basis, is less than 75% of the “additional rate” for the relevant tax year.\(^6\) (The “additional rate” is the top rate of tax for the employment income of individuals and is currently 45%). HM Treasury can change the comparator rate by regulation (subject to Parliamentary veto). Although it is normally a precondition for a valid UK claim for a foreign tax credit that all reasonable steps have been taken to minimise any amounts of foreign tax payable, here that condition is automatically assumed to have been satisfied.

By referring to the amount the employee would be able to claim by way of foreign tax credit relief, the government has gone beyond its announcement in December that the test would be whether a comparable level of tax was payable overseas. The main reason for doing so was probably to bring in the rule in the UK’s foreign tax credit code that denies relief where the non-UK tax for which credit is claimed is later repaid. But this could have been achieved by saying so explicitly, rather than cross-referring to the credit rules.

Applying the credit rules brings problems. One of these is that the amount of the credit is limited to the amount of UK tax chargeable on the income, assuming that it is the top slice of income. For example,

\(^5\) The list is no doubt informed by the arguments HMRC has run when claiming that dual contract arrangements constitute the artificial splitting of a single employment.

\(^6\) The UK also takes 75% of its own tax rate as the benchmark of a low rate in the context of its controlled foreign company rules (although the way the ratio is calculated there is more complex), so the use of that percentage is not surprising.
assume that foreign tax is payable at 35%, but the taxpayer pays income tax in the UK at the basic rate, currently 20%. Credit would be limited to 20% – well below the 33.75% needed to prevent the draft rules from applying. One would normally expect an employee with a dual contract arrangement to earn enough to be well into the UK’s top tax brackets, but he or she may have made gifts to charity or be able to claim other reliefs to reduce his or her taxable income. There is no principled reason why this should trip the employee into paying tax on an arising basis; it makes compliance harder, as the employee may have to work through a tax computation once to determine whether the rules apply and then a second time if they do; and the arising basis may entail an incremental tax liability if the employee has in fact failed to minimise the foreign tax on the income. The government should fix this.

The other problems stem from difficulties with the credit rules themselves. For example, the UK rules for crediting income tax levied at state level in the US can be more restrictive than those for crediting US federal income tax. Moreover, the UK may take a different view from another jurisdiction of what is the source of income to be taxed. In last year’s Court of Appeal decision in *Anson*, the taxpayer was not able to claim credit against UK tax on the distributions from an LLC because the US tax was levied on the income of the LLC itself; economically, though, the tax was suffered on the same income. In the employment context, a mismatch is perhaps most likely to arise from the operation of the UK’s disguised remuneration rules: the UK rules may see income as arising at a stage when the jurisdiction where the services are performed does not.

**COMMENT**

The proposed rules broadly do what was announced in December, except for some aspects of the test for a comparable level of tax.

They are almost certain to become law in some form, although the details could change during consultation or in the course of the legislative process. Improvements to the 75% formula would be welcome. Most of the Parliamentary process will take place after 6 April, when the rules are due to come in. If, however, Parliament makes substantive changes detrimental to taxpayers after that date, the usual practice would be for the changes not to take effect until the date of the announcement at the earliest.

Employers and employees operating dual contract arrangements (or considering doing so) should keep a close eye on the proposals as they develop up to 6 April and beyond.

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